The External Debt

By Evan Drummond

The United States is a debtor nation. In just five years—from 1982 to 1987—it moved from being the largest creditor nation to being the largest debtor nation in the world. Its external debt now far surpasses the external debt of Mexico and Brazil combined and is approaching $300 billion. What are the causes and consequences of this external debt? And, what are the implications for the U.S. agricultural sector?

External Debt: What Is It?

The U.S. external debt is the difference between the assets in other countries owned by Americans and the assets in the United States owned by foreigners.

Americans and their government own foreign assets. For example, I have a perfectly legal savings account at a bank in Canada. Therefore, I (an American) am the owner of a foreign asset (a claim against the Canadian bank). U.S. ownership of foreign assets usually comes about in four ways:

- Direct investments—American companies buy foreign companies or other tangible assets;
- Fnancial investments—American investors buy foreign stocks and bonds;
- Government claims—the U.S. Government makes a loan to a foreign government and thus establishes a claim against it;
- Bank loans—a U.S. bank loans money to a foreign government, corporation or individual.

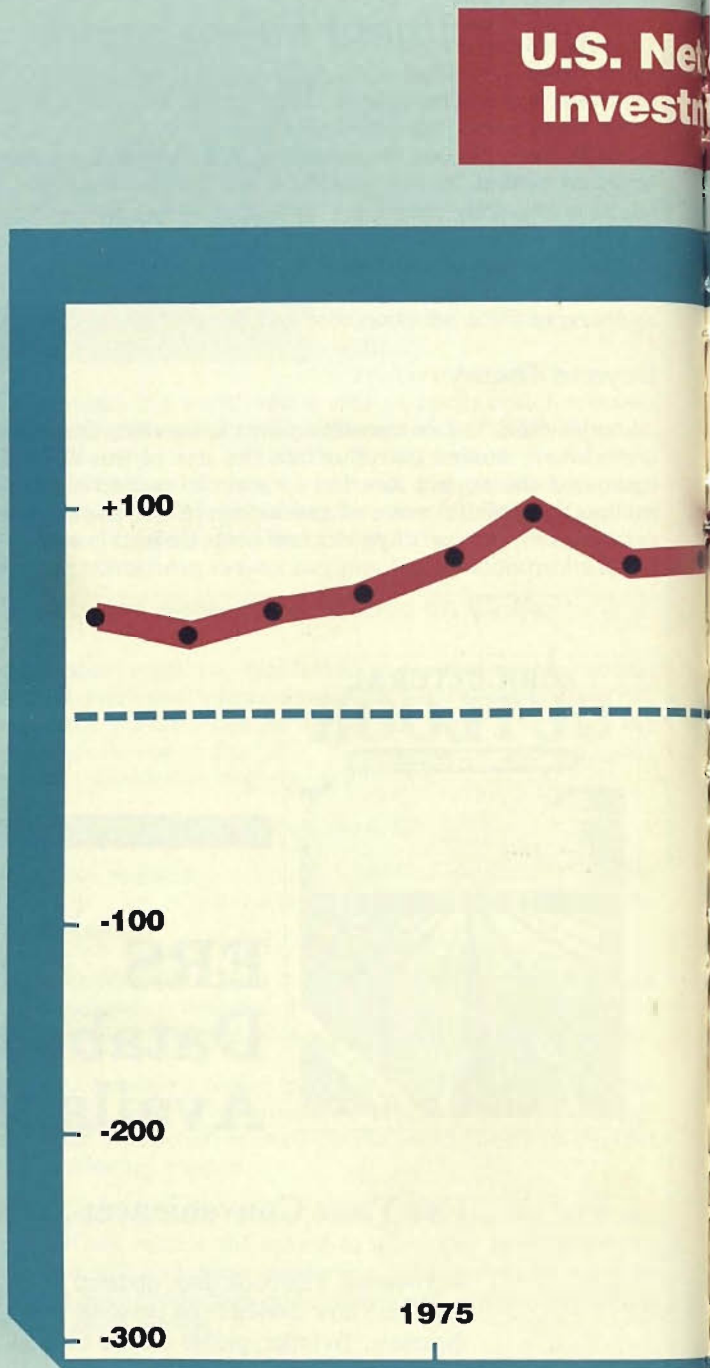
Foreigners own U.S. assets in the same way and for the same reasons that Americans own foreign assets.

How We Got There

In the early history of the U.S. we were a debtor nation. Individual companies and the government borrowed from abroad to finance the development of our country. Conditions changed shortly after World War I as the U.S. supported massive reconstruction programs in Europe. These programs were often implemented on a loan basis, and many foreign governments became deeply in debt to the U.S. The U.S. ownership of assets in other countries expanded after World War II as well. In the 1950's, for example, there were major concerns that the size of the U.S. external surplus could effectively put the rest of the world into permanent debtor status.

By the 1980's the tide had begun to turn. There were many factors involved in the change of the U.S. from being a creditor to being a debtor country. However, two factors have caused most of the change: (1) expanding debt by Americans and by the U.S. Government and (2) high real interest rates.

Expanding Debt. Americans and their government have been on a real debt binge in the 1980's. With a declining savings rate and increased borrowing, American consumers, in the aggregate, are spending more than they save. Certainly our government is spending more than it earns resulting in budget deficits or internal debt.



This growth of domestic debt is being financed quite simply by borrowing from foreigners. In fact, one of the largest group of buyers of Treasury debt is foreign investors. That is, foreigners are lending money to Uncle Sam to pursue the current "guns AND butter" policies.

High Real Interest Rates. The second major factor pushing

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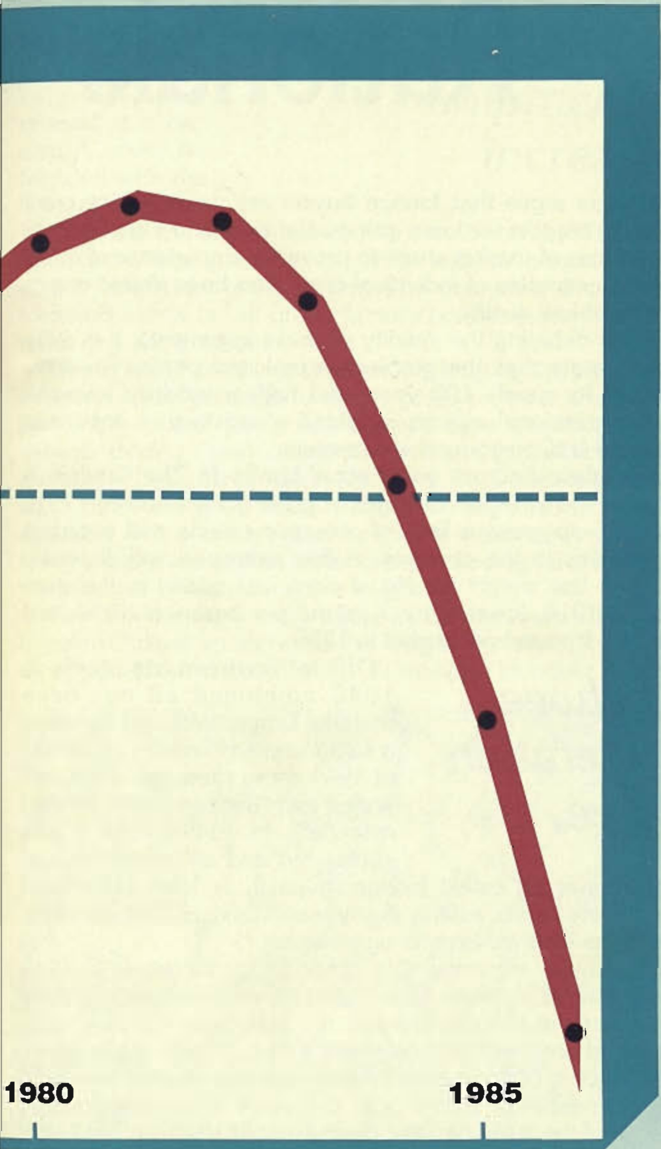

ebtor status began in October 1979 when the then-recently nted chairman of the Federal Reserve Board, Paul Volcker, nced that, henceforth, controlling the rate of growth of credit be the primary policy objective of the Fed. By doing this, Mr. r argued, it would be possible to control inflation. In retrospect, his policies certainly controlled inflation, but they did so by pushing the REAL rate of interest (the nominal or stated interest rate minus the rate of inflation) to unprecedented levels. Prior to Mr. Volcker's policy shift, the real rate of interest was usually one or two percent. In recent years, real rates of interest in the U.S. have been in the five to seven percent range.

Foreign investors, reacting to the relatively high real rates of interest in the U.S., expanded their purchases of U.S. assets during the 1980's. Much of the "fuel" that drove the U.S. stock market on its wild, upward rush came from foreign investors who perceived U.S. assets to be relatively cheap. As foreigners invested in the U.S. and increased their claims against Americans, the U.S. became more and more of a debtor nation.

Problems

To be a debtor nation is not inherently "bad" or "good"; but several aspects of the recent movement of the United States from a creditor to a debtor nation are worrisome.

First, the growth of Federal budget deficits (the internal debt) has been financed by a growth of the external debt. Since Americans aren't absorbing the impact of chronic budget deficits, there is little political will to stem the tide of domestic red ink. Unfortunately, the extension of foreign credit to the U.S. won't go on forever—sometime our creditors will tell us that our available line of credit has been used up. At that time we will once again have to choose between "guns OR butter" and/or raise taxes.

Secondly, the growing external debt drove up the price of the dollar on world financial markets. The Japanese investor who wished to buy assets in the U.S. first had to purchase dollars with which to buy the assets. As foreign investors bought U.S. assets, they competed with one another to buy dollars and hence drove the price of dollars up. As the price of the dollar was bid up, the dollar price of goods and services imported into the U.S. declined and the foreign price of goods exported from the U.S. increased. This adversely affected U.S. agricultural exports.

Thirdly, a lot of foreign money that has moved into U.S. assets during the 1980's is "hot money"—money prone to move in or out of a particular country very rapidly as the perceived investment climate changes. If foreign investors become bearish on U.S. assets, a run could well develop as foreigners rush to get out of U.S. assets before their price falls further. This is part of what happened in the stock market. Even more troublesome is the distinct possibility that a panic could develop in the international banking system—the likes of which has not been seen since the Great Depression.

So, while being a debtor nation is not inherently "good" or "bad", the current situation in the U.S. is not at all healthy. We have become a debtor nation for all of the wrong reasons—to consume rather than to invest. And, much of the foreign investment that we are attracting is the kind of money that enhances financial volatility. We, as a nation, are behaving like a credit card junkie. And like the credit card junkie, we—or our children—will eventually have to pay the bills out of current income.